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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 1382

NORTHEASTERN CONSOLIDATED COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. 10a–19a) is reported at 279 F. Supp. 592. The opinion of the court of appeals (Pet. 1a–9a) is reported at 406 F. 2d 76.

JURISDICTION

The judgment of the court of appeals was entered on January 6, 1969. The petition for rehearing was denied on February 17, 1969. The petition for a writ of certiorari was filed on May 10, 1969. The jurisdiction of the Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below properly characterized advances petitioner made to a corporation controlled by its sole shareholder as contributions to capital so that the resulting loss was a capital loss rather than a bad debt.

STATUTE INVOLVED

Sections 165 and 166 of the Internal Revenue Code of 1954 are set forth in the petition (Pet. 20a–22a).

STATEMENT

Petitioner is a Delaware corporation which was organized in 1949 under the name Consolidated Gas and Service Company. Its operations involved the construction of gas distribution facilities. John C. Donnelly owned all the capital stock. (Pet. 10a.)

In 1954, a separate company, Northeastern Electric Construction Corporation (Necco), was organized to engage in electrical construction work for one of the petitioner's most important customers. Donnelly and Arthur Schmidt, an officer of petitioner, were the stockholders. A separate corporate entity was used to conform to rules of the International Brotherhood of Electrical Workers, which would contract only with companies doing exclusively electrical work. (Pet. 10a–11a.)

Necco's initial capital was about $12,000. From the end of 1954 to March 1956, Delaware Consolidated advanced over $300,000 to or on behalf of Necco, primarily for operating expenses such as payrolls, materials and overhead. Although petitioner carried the advances as accounts receivable, no written evidences of indebtedness were given, no interest or

maturity date was agreed upon, and no security was provided." (Pet. 11a.)

Necco incurred serious losses from its inception. In March 1956, it was decided to merge the two companies into one, the present petitioner, with a transfer of Necco's assets to petitioner. There is no evidence of any payments or credits against the advances up to the time of the merger. As part of the merger the value of Necco's properties were applied against the advances. The amount left unreimbursed—$199,791.09—was cancelled on petitioner's books of account. (Pet. 11a.)

Petitioner claimed a bad debt deduction for the $199,791.09, for its taxable year ending March 31, 1956. The Commissioner of Internal Revenue first allowed the deduction, including the carry-back of petitioner's resultant 1956 net operating loss to 1954 and 1955, but subsequently disallowed it and assessed deficiencies.[1] Petitioner paid the deficiencies and filed claims for refund. The claims were denied by the Commissioner and petitioner filed this suit in the district court. (Pet. 11a.) That court rendered judgment for the government (Pet. 19a). The court of appeals, one judge dissenting, affirmed (Pet. 1a–9a).

[1] As part of the merger effected in 1956, Necco's own net operating loss, which totalled about $187,000 at the time of merger, was made available to petitioner as an offset against its taxable income. Petitioner claimed and was allowed carry-over deductions for 1959, 1960 and 1961 aggregating approximately $85,000. (Pet. 11a–12a.)

ARGUMENT

The decision below is correct and there is no conflict of decision that calls for further review.

1. To justify a business bad debt deduction under Section 166 of the Internal Revenue Code of 1954, a taxpayer must first demonstrate that a true indebtedness existed. Petitioner's advances to Necco must be characterized as debt or capital investment according to the substance, rather than the form, of what occurred. *Higgins* v. *Smith,* 308 U.S. 473, 477. The underlying determinant is that an investor's prospects of return are contingent upon the successful operation of the corporate venture, while the lender's are not. In any particular case a variety of factors must be evaluated in the light of this underlying distinction. The pertinent criteria were most recently summarized thusly (*Berkowitz* v. *United States,* 69–1 CCH Tax Cases ¶ 9398, at p. 84,636 (C.A. 5)):

> There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stock-

holder; (10) payment of interest only out of "dividend" money; (11) the ability of the corporation to obtain loans from outside lending institutions.

The circuits generally agree. See, *e.g.*, *Gilbert* v. *Commissioner*, 248 F. 2d 399 (C.A. 2); *Fin Hay Realty Co.* v. *United States*, 398 F. 2d 694 (C.A. 3); *Wood Preserving Corp. of Baltimore* v. *United States*, 347 F. 2d 117 (C.A. 4); *Tomlinson* v. *1661 Corp.*, 377 F. 2d 291 (C.A. 5); *Moughon* v. *Commissioner*, 329 F. 2d 399 (C.A. 6); *Burr Oaks Corp.* v. *Commissioner*, 365 F. 2d 24, 27 (C.A. 7); *Taft* v. *United States*, 314 F. 2d 620 (C.A. 9); *Covey Investment Co.* v. *United States*, 377 F. 2d 403 (C.A. 10).

As the majority opinion below recognized (Pet. App. 3a), analysis of these factors in this case militates against the conclusion that a *bona fide* debt existed. Necco was thinly capitalized, repayment was contingent on Necco's success, Necco and petitioner had some identity of interest, and comparable outside lending was unavailable. Only the nomenclature the parties used to describe the transaction supports petitioner's claim that a debt existed, and that fact alone cannot overcome the significant indications of a capital contribution shown in this record.

2. There is not, as petitioner argues (Pet. 12–13), a present conflict between the decision here and the position of the Sixth Circuit evidenced in *Byerlite Corp.* v. *Williams*, 286 F. 2d 285, and the Court of Claims decision in *American Processing & Sales Co.* v. *United States*, 371 F. 2d 842. There are similarities

between the instant case and those cases, but the considerable amount of litigation in this area shows a multitude of variations depending upon the facts of each case. The decision in each instance must rest on a balancing of the relative weight of a mixture of facts which seldom present themselves again in the same proportion. The result is that square precedent is rarely encountered. See Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed.) Sec. 4.02, p. 122. Certiorari should be granted to resolve a conflict, we suggest, only in those instances where the lower courts have disagreed as to the characterization to be given virtually identical factual patterns or where a court, in disagreement with the decisions cited at pp. 4–5, *supra,* holds that one of the enumerated factors either should be given no weight or should be considered dispositive.

Neither of these suggested criteria would justify review of this case. As the Court of Claims noted in *American Processing, supra,* 371 F. 2d at 855, both there and in *Byerlite* credits were made against the advances in the form of delivered materials. In each case, the credits indicated that, in economic substance, the advances were treated as loans by the "borrower", thus suggesting the parties intended that the advances would be repaid. No such evidence appears in the instant case.[2]

[2] There is no inconsistency (see Pet. 17) in the government's arguments respecting Section 165(g)(3) of the Internal Revenue Code of 1954. Section 165(g)(3) provides in relevant part that any security of a corporation affiliated with the taxpayer shall not be treated as a capital asset. This statute fails to apply

It is true that language in *Byerlite* suggests that the parties' nomenclature and purported intent to create a debt controlled, without regard to the presence of other factors indicating the existence of a capital investment. But this does not provide an adequate basis for a grant of certiorari, since intervening developments indicate that *Byerlite* no longer expresses the position of the Sixth Circuit. In *Moughon* v. *Commissioner,* 329 F. 2d 399, and *Foresun, Inc.* v. *Commissioner,* 348 F. 2d 1006, the Sixth Circuit had occasion to review the debt-equity issue anew. In both cases, the court adopted the generally accepted objective criteria for resolution of the debt-equity issue. See pp. 4–5, *supra.* It avoided any reference to *Byerlite* in either opinion, which led Chief Judge Thomsen in *Wood Preserving Corp. of Baltimore* v. *United States,* 233 F. Supp. 600 (D. Md.), affirmed, 347 F. 2d 117 (C.A. 4), to observe (233 F. Supp. at 605) that the *Byerlite* decision "has been considerably weakened by Moughon". There has been no countervailing indication that at the present time *Byerlite* is of controlling significance in the Sixth Circuit. Rather, it appears that *Byerlite* is to be lim-

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here for two independent reasons: first, Necco does not qualify as an affiliated corporation, since (see Section 165(g)(3)(A)), petitioner did not own at least 95 percent of each class of Necco's stock; and, second, because its investment in Necco did not, in the statutory sense, become "worthless," but was merely impaired to the extent of the loss occasioned by the subsequent merger of Necco with petitioner. Petitioner never questions either of these facts.

ited to its own facts, even in its own circuit.[3] Any thought that the Court of Claims, in its reliance on *Byerlite,* has ventured an approach different from or in conflict with that taken in the circuits is put to rest by the following passage in *American Processing* (371 F. 2d at 848):

> There is no dearth of cases in this province of tax law. So large is their number and disparate their facts, that for every parallel found, a qualification hides in the thicket. At most they offer tentative clues to what is debt and what is equity for tax purposes; but in the final analysis each case must rest and be decided upon its own unique factual flavor, dissimilar from all others, for the intention to create a debt is a compound of many diverse external elements pointing in the end to what is essentially a subjective conclusion. Elsewhere these elements have included such criteria as the "real intention" or "true intention" of the parties as expressed in the instrument of debt and corroborated by surrounding facts; ratio of debt to equity in the financial structure of the debtor (i.e., the "thin incorporation" line of decisions which enjoyed a decade of popularity); reasonable expectation of repayment regardless of the success of the venture; substantial economic reality of the transaction; and maintenance of proportional

[3] Subjective intent or motivation should not have the significance *Byerlite* attaches to it. A taxpayer's allegations of what it thought it was doing, or meant to do, have at most marginal relevance in determining what it in fact did do. See, *e.g., Tomlinson* v. *1661 Corp., supra,* 377 F. 2d at 299; cf. *Knetsch* v. *United States,* 364 U.S. 361, 365; *United States* v. *Estate of Grace,* No. 574, O.T., 1968, decided June 2, 1969.

holdings by stockholders whose purported loans remain in suspicious balance with their capital contributions.

3. Nor is there a conflict with this Court's decision in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46, or any of the various court of appeals decisions cited at pp. 14–17 of the petition. Those cases do not remotely suggest, as petitioner would apparently have it, that securities owned by a corporate taxpayer are generally non-capital assets. Rather the cases are exceptions to the general rule that a "security" investment in a corporate[4] is a capital asset, and rests on special factual contexts which in no way resemble the instant case.

In *Corn Products*, the Court was asked to decide whether the taxpayer, a manufacturer of corn by-products, was entitled to capital gains treatment on its profit from dealing in corn futures. The decision that the profits were ordinary income proceeded from the fact that the taxpayer's "long position" in corn futures was established "'as a part of its corn buying

[4] Although it is unquestioned that the definition of a capital asset must be narrowly construed, a corporate security is generally a capital asset because it represents investment in a corporate venture placed at the risk of the enterprise over an indefinite future, except in certain very special situations. Section 165 of the Code, among others, supports this premise, since it is only by express exception (Section 165(g)(3)) that a worthless security is given ordinary loss treatment. See, also, Section 341 (collapsible corporations), Section 582 (securities held by a dealer), and Sections 1242 through 1244 (relating to small business investment companies and stock of small businesses). In contrast, no section affirmatively defines a special type of security to be a capital asset.

program' and 'as the most economical method of obtaining an adequate supply of raw corn' " (350 U.S. at 48) and that it therefore constituted an integral part of its manufacturing business (350 U.S. at 51). In contrast, the operation of Necco, in the instant case, was not an integral part of petitioner's business, but was a separate and distinct field of endeavor which Donnelly decided to enter.

In each of the court of appeals decisions which petitioner cites, the expenditures either were undertaken to alleviate temporarily some impediment to the operation of the business, or were an integral part of a non-capital item, such as the acquisition of raw materials. In *Booth Newspapers, Inc.* v. *United States,* 303 F. 2d 916, 921 (St. Cl.), the taxpayers purchased stock in a paper manufacturing company, but only to insure a short term source of newsprint. In *Lutz* v. *Commissioner,* 282 F. 2d 614, 619 (C.A. 5), payments to creditors of the taxpayer's wholly owned corporation were necessary to retain an agricultural commodity brokerage license. In *United Gas Improvement Co.* v. *Commissioner,* 240 F. 2d 312 (C.A. 3), the taxpayer made short-term advances to a controlled subsidiary corporation to enable the subsidiary to meet its current dividend obligations. In *Five Star Manufacturing Co.* v. *Commissioner,* 355 F. 2d 724, 727 (C.A. 5), the holding of one shareholder was purchased in order to free the management from "unwarranted fetters". In *Commissioner* v. *Bagley & Sewall Co.,* 221 F. 2d 944, 947 (C.A. 2), the taxpayer had purchased government bonds

to guarantee performance of its purchase contract with a foreign corporation; and in substance the bonds served the function of a performance bond.[5]

Petitioner's sole shareholder, Donnelly, desired to enter the electrical contracting business. While this new venture in part permitted it to service an existing customer (Pet. 11a), the activity was an attempt to expand its operations permanently. Petitioner's advances represented capital placed at the risk of Necco's operations over an indefinite time in the future, and there is no precedent for allowing an ordinary loss deduction upon the unprofitable termination of Necco's operations.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[5] In *Daily Journal Co.* v. *Commissioner*, 135 F. 2d 687, 688 (C.A. 9), the only question was whether salary paid to the taxpayer's president was reasonable in relation to the services performed.

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